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East Asian Cooperation: The ASEAN View

Gloria O. Pasadilla

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For comments, suggestions or further inquiries please contact:

The Research Information Staff, Philippine Institute for Development Studies
3rd Floor, NEDA sa Makati Building, 106 Amorsolo Street, Legaspi Village, Makati City, Philippines
Tel Nos: 8924059 and 8935705; Fax No: 8939589; E-mail: publications@pidsnet.pids.gov.ph
Or visit our website at http://www.pids.gov.ph

Abstract

The paper discusses the ASEAN + 3 integration in the context of the literature on hub-and-spoke regionalism. It argues that, provided proper rules of origin are incorporated, the different bilateral arrangements between ASEAN countries and each of the three East Asian economies are building blocs towards an East Asian FTA. It argues that the bilateral arrangements skirt the slow decision process which marks the 'ASEAN way' and create some sort of 'coalition of the willing' that can, eventually, set the pace of integration for the rest of East Asia. Because of the region's so-called leadership vacuum, the paper also underscores the important role of ASEAN in bringing any discussion on East Asian integration on the table.

Keywords: economic integration, ASEAN, AFTA, trade bloc

East Asian Cooperation: The ASEAN View

Gloria O. Pasadilla, PhD
University of Asia and the Pacific and Philippine Institute for Development Studies
Manila, Philippines[1]

This paper is one ASEAN national's reflection on the current developments in integration in the East Asian region. The basis for such a reflection is primarily, economic, particularly, trade. Admittedly, the ASEAN grouping and all the recent forms of integration encompass a far larger scope than merely trade among members. For instance, ASEAN cooperation covers Environment, Anti-Terrorism, Anti drug trafficking, as well as monetary and financial cooperation. And, from its original inception, ASEAN was built to address peace and security concerns in the Southeast Asian region, not primarily to tackle trade issues. Unlike the EU which started out as a way to address economic coordination, particularly, Iron and Steel production between France and Germany,[2] subsequently moving towards more and more political integration, ASEAN began for an expressedly political purpose - to solve territorial and political disputes peacefully. Economics and trade discussions figured more prominently only much later, after the Cold War security issues have abated.

Despite its narrow scope, reflection on ASEAN and a future East Asian integration from the economic prism offers an illuminating perspective. In the first place, economic imperatives, not political ones, are driving the ASEAN and East Asian to bond together in a stronger fashion, not to cut itself off from the rest of the world, but to lessen the region's dependence on the US and EU markets and to rely more on a diversified and strong Asian regional market. Other economic push are likewise affecting the Asian integration, in particular, the current trends of regionalism elsewhere as well as the slow pace of multilateral efforts. North America, Africa, and Europe are trying to integrate their economies more and more, forcing Asians to, likewise, look more inwardly. The improved standard of living apparently caused by the EU integration also adds to the attractiveness of similar integration projects in East Asia. Lastly, the last Asian crisis also fostered a more inward, akin to soul-searching, look at themselves as a region, and revitalized a desire to build a stronger regional capacity to help each other out in the next crunchtime.

All these incentives driving greater East Asian cooperation are economic. The region has little of the political motivations that drive Europe to unite, namely to prevent wars by increasing interlocking economic interests, and more recently, to be able to break the hegemony of the United States. Asia also has less cultural and historical ties that can aid greater unification. Unlike Europe which shares a common deep Christian root, history and culture, and is relatively homogeneous in living standards, Asia is very diverse in culture, religion, language, historical

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[2] Much of the economic integration in Europe, however, had an underlying political objective of avoiding the repeat of European wars that arose, primarily, from German and French rivalry.

experience, ethnicity, and levels of development. What is uniting them and driving the Asian integration process are, fundamentally, economic considerations.

If, then, economics is the driving force behind greater East Asian cooperation, it stands to reason to evaluate the economic logic that is influencing the process. Since economics is about tradeoffs and of benefits and costs, the paper's reflection on East Asian integration will therefore discuss these potential benefits and costs under different scenario, in particular, under different possible hub-and-spoke trading arrangements with Japan or China or Korea, and/or various combinations of plurilateral agreements. In the next section, it will first discuss some selected historical landmarks in the formation of the ASEAN as a regional organization to trace its progressive evolution from being a regional forum for security questions, to a more integrated regional market and Free Trade Area. Next, it shifts to the economics of the hub-and-spoke phenomenon and plurilateral-like agreements. The paper then shifts to a political economy discussion of the potentially important role of ASEAN for an East Asian FTA to come about. It discusses the questions and problems that beset ASEAN member nations which prevents it from playing an even more constructive and indispensable role in the East Asian region.

I. The ASEAN Evolution: ASEAN, AFTA, and East Asian FTA

From its modest beginning of providing a regional framework in which disputes could be dealt with peacefully and without resort to force, ASEAN continues to evolve into a major influence for greater regional cohesion not only for Southeast Asia but also for the entire East Asia. This section briefly sketches the major milestones in the evolution of the ASEAN.

The Beginnings and Enlargement

ASEAN was founded on August 8, 1967 amidst gloomy circumstances: Indonesia had just emerged from a period of confrontation with Malaysia and Singapore; Malaysia and Singapore had just been through an acrimonious separation, and the Philippines was pursuing its claim to Sabah, a part of Malaysia (Severino, 2002a). Around the same period, communism and the 'free world' was competing for followings in the region. Thailand was bordered by communist Cambodia and Vietnam and was, itself, threatened within by communist insurgency in the Northeast. China was in the throes of the cultural revolution; Vietnam was at war; and Myanmar did not want to have anything to do with international organizations. All in all, a good part of Asia was in turmoil and threatened by communism.

In response to this situation, the five countries of Indonesia, Malaysia, Philippines, Singapore, and Thailand formed ASEAN. The "Bangkok declaration", which the ministers of these countries signed, emphasized the "desire to end external interference and take primary responsibility in regional affairs." The association was, thus, a hedge against further embroilment in the rivalries of powers, particularly Communist China and the US. Interestingly, from its foundation, ASEAN was declared open for membership to <u>all</u> countries in Southeast Asia, even as the region was then divided between ASEAN's five members and the rest.

In 1976, after the end of the Vietnam war, ASEAN leaders established the ASEAN Secretariat to improve coordination among ASEAN members, and signed the Treaty of Amity and Cooperation (TAC). This treaty enshrined one of ASEAN's fundamental principles – that of non-interference in each other's internal affairs. This principle was an important reason for the other Southeast Asian nations to join the young regional grouping.

In 1984, Brunei Darussalam joined ASEAN immediately after its independence from the UK. In 1995, Vietnam, still under a communist system, was also admitted, heralding a new era in Southeast Asia in which ideological and political differences were no longer considered a hindrance to regional cooperation (Chalermpalanupap, 2002). Laos and Myanmar (formerly, Burma) joined ASEAN in 1997, and Cambodia in 1999. With the last membership of Cambodia, all nations of Southeast Asia finally came under one ASEAN roof.

Thus, in its first 25-year history, ASEAN sought to stabilize the region. It consolidated its foundations and processes, provided a framework and an environment for peaceful relations among its members, and took a leading part in the management of the new situation that emerged from the Vietnam war (Severino, 2002a).

Box 1. Selected Historical Highlights of ASEAN

A. On ASEAN Formation

1967	ASEAN was founded. Founding members: Indonesia, Malaysia, Philippines, Thailand, and Singapore. Important document: Bangkok Declaration.
1976	ASEAN Secretariat was established. Spelled program of action to include political, economic, social, cultural, information, security. Treaty of Amity and Cooperation (TAC) was signed.
1984	Brunei Darussalam joined ASEAN
1995	Vietnam joined
1997	Laos and Myanmar joined
1999	Cambodia. All Southeast Asian countries are now ASEAN members

B. ASEAN Free Trade Area

1992	ASEAN endorsed AFTA. Important document: Framework Agreement on Enhancing ASEAN Economic Cooperation.
1994	Agreement to accelerate realization of AFTA from 15 years to 10 years by 2003. First ASEAN Regional Forum
1995	Accelerated tariff reduction to 2002. Abolition of tariff by 2010 for first 6 members, by 2015 for newer members.

C. East Asian FTA

1997	First ASEAN +3 Summit in Malaysia, followed by successive ASEAN+1 Summit. Common theme of summits: cooperation between ASEAN-Japan, ASEAN-Korea, and ASEAN-China, to become building blocks for regional cooperation in East Asia
1998	Hanoi Summit. Agreement to form East Asia Vision Group (EAVG)
1998-2001	EAVG worked to discuss future cooperation in East Asia. Submitted recommendation in 2001
1999	East Asia Study Group (EASG) was formed to study practical ways and means to deepen and expand existing cooperation, Assess EAVG Recommendation. Prepare Action Plans

Growth in economic interdependence

By the 1990s, with the Cold War over, with China rapidly opening itself up to the world economy, and with globalization gathering momentum, ASEAN's response was to make itself into a free trade area, by reducing and eventually abolishing tariff and non-tariff barriers to trade among themselves. Thus, ASEAN Free Trade Area (AFTA) was initiated in 1992. Unlike the ASEAN Preferential Trade Agreement in 1977, the AFTA Common Effective Preferential Tariff (CEPT) Scheme encompasses a far larger scope. Not only does it include a greater number of products subject for lower tariffs, but it also includes provisions for the elimination of non-tariff barriers, quantitative restrictions, and other cross-border measures. As a result, in 2003, tariffs of roughly 82.46% of tariff lines dropped to no more than five percent in the first six ASEAN members which, not coincidentally, are the region's leading trading nations. Average tariffs in these six economies is as low as 2.27% (see Table 1). By 2010, all tariffs are expected to disappear. The newer members, meanwhile, have been given a longer period (until 2015) to comply with the Common Effective Preferential Tariff (CEPT) Scheme. Delays in the inclusion of products in the AFTA scheme or suspensions of AFTA concessions are governed under stringent conditions.[3]

Table 1 - ASEAN Tariffs

Country	Average CEPT Tariff Rates		Inclusion List	Total	% Inclusion of Total
	2000	2003			
Brunei	1.26	0.96	6,276	6,492	96.67
Cambodia	10.4	7.96	3,115	6,822	45.66
Indonesia	4.77	2.16	7,158	7,252	98.70
Laos	7.07	5.66	1,247	3,551	35.12
Myanmar	2.85	2.07	2,386	5,472	43.60
Malaysia	4.38	3.19	8,859	9,213	96.16
Philippines	4.97	3.77	5,571	5,695	97.82
Singapore	0	0	5,739	5,859	97.95
Thailand	6.07	4.63	9,103	9,110	99.92
Viet Nam	7.09	N/A	3,573	4,827	74.02
ASEAN	3.74	2.63	53,026	64,300	82.47

Regional CEPT tariff rates are weighted average with the number of tariff lines in the Inclusion List for 1999 used as the weights.

Source: ASEAN Secretariat

Several factors helped in the formation of the AFTA. Some were external, like the growing trend in regionalism elsewhere, particularly NAFTA and EU integration, which prompted Asia to likewise look inwards. But internally, the region had also undergone a transformation, from being highly export dependent on markets outside the region, to being more

[3] The AFTA CEPT is dubbed as WTO-plus in the sense that the liberalization commitments of countries have gone beyond what has, so far, been agreed upon in the multilateral setting.

economically interdependent. Starting in the 1980s, intra-ASEAN trade has grown steadily. For most countries, exports to and imports from other ASEAN countries, in terms of percentage of total, have increased in the 1990s (see Table 2).

Table 2. Intra-ASEAN Trade (% of Total)

	Exports to ASEAN			***Imports from ASEAN***		
	1991	***1999***	***2000***	***1991***	***1999***	***2000***
Brunei	18.33	15.16	29.48	36.15	62.44	50.06
Indonesia	11.45	16.71	17.52	9.86	19.84	20.23
Malaysia	29.33	23.5	24.87	20.08	23.53	20.01
Philippines	7.21	14.21	15.71	9.45	14.61	15.79
Singapore	23.33	25.14	27.31	19.1	23.54	24.72
Thailand	11.77	16.6	21.80	12.78	15.49	16.92
Vietnam	18.03	15.03	…	13.07	25.8	…

Source of Basic Data: PC-TAS, NAPES Database and ASEAN Secretariat

Much of this growth in intra-ASEAN trade is largely attributed to the growth in intra-firm trade among Transnational Corporations (TNCs) operating in the region. In the second half of 1980s, Japanese TNCs feared the erosion of their competitiveness in global trade because of surging wages rates and the yen currency appreciation. To preserve their lead, they moved some of the production processes from Japan, particularly those that were more labor intensive and a few capital- and skill-intensive ones, to the Newly Industrializing Economies (NIEs) and then to Southeast Asia, where wage rates were relatively lower. These different production segments were then linked together through international subcontracting or outsourcing arrangements, creating a highly vertically integrated process of production within the region. Thus, a Japanese car export to the US, may have part of the wheels and tires manufactured in Malaysia, its radio produced in Singapore, and perhaps assembled in the Philippines. US TNCs, likewise, eventually adopted the same production strategy, fuelling further increase in intra-regional trade. The desire to have an optimal procurement system for the vertically integrated companies greatly influenced the motivation behind the development of the ASEAN Free Trade Area (AFTA). With the reduction of trade barriers, intra-regional trade more than doubled from \$44.2 billion in 1993 to \$97.8 billion in 2000.

The logic of increasing liberalization has been extended to services trade. In 1995, ASEAN concluded the Framework Agreement on Services (AFAS). So, far, the third package of specific sector commitments have been submitted. But agricultural products remain a subject for further liberalization as well as other sensitive sectors not previously integrated in the Inclusion List of countries under the CEPT program.

On to East Asian FTA?

While ASEAN members have laboriously made concerted efforts to unify Southeast Asian nations, they have never lost sight of the need to engage their external partners, particularly, Japan, China, and South Korea. ASEAN has had dialogue with Japan since 1973, with South Korea since 1989, and with China since 1991. The three countries joined ASEAN in launching the ASEAN Regional Forum (ARF), an ASEAN Dialogue with all its Partners,[4] in 1994. In 1997, the historic inaugural meeting of ASEAN+3 Summit took place which was followed by three successive ASEAN+1 summits. The different bilateral Joint Statements expressed agreement on the need to consolidate their close economic relations by promoting trade and investment, facilitating market access, and other various modes of economic cooperation. They also contained a recognition that the stability and prosperity of Northeast and Southeast Asia are closely interlinked.

The East Asia Vision Group (EAVG), composed of academics and other non-government official experts and representatives from each of the ASEAN member countries, was set up in 1998 to discuss the future of cooperation in East Asia and to submit recommendations for the 2001 Summit. Likewise, an official East Asia Study Group (EASG) composed of senior officials and the ASEAN Secretariat was set up in 2000 to assess the recommendations of EAVG, to explore practical ways and means to deepen and expand the existing cooperation in East Asia, and prepare concrete measures and action plans.

Interestingly, the EAVG study was entitled: *Towards an East Asian Community: Region of Peace, Prosperity and Progress*. One of its major recommendations is the establishment of an East Asian Free Trade Area (EAFTA), starting with an interim step of linking existing free trade areas in East Asia together. It also recommended the evolution of ASEAN+3 Summit to East Asian Summit and the institutionalization of the East Asia cooperation process to create regular channels of communications and cooperation. Implicitly, the evolution to the East Asian Summit seems to entail the creation of an East Asian Community as a new regional organization (Chalermpalanupap, 2002).

The EASG recommended 26 measures selected from the EAVG recommendations. It included the formation of EAFTA and the evolution of ASEAN+3 Summit into an East Asian Summit as long-term measures. It also recommended the formation of an East Asia Forum, an East Asia Business Council and a network of East Asian eminent intellectuals, and the promotion of East Asian studies as part of the short-term measures.

Summing up, from an association designed to address peace and security problems in the region, ASEAN has evolved into a more closely integrated Free Trade Area, and might yet evolve into a larger East Asian Community. The underlying driving force for East Asian integration is economics: large Chinese market, greater leverage in multipolar world, fear of US trade deficit backlash, regionalism in other parts of the world. Whether East Asia would be like the EU is, at least at this point, a moot question. Nevertheless, though East Asia is yet far from looking like the EU, domestic and external forces, as well as the logic of globalization, is likely going to make East Asia resemble EU more closely than it does today (Severino, 2001). But with it come the corresponding benefits and costs.

[4] This includes Australia, Canada, EU, Japan, South Korea, New Zealand, US, China, Russia.

II. Hub-and-Spoke Regionalism: Potential Benefits for ASEAN

Since the East Asian FTA is a long term goal, the more immediate concerns at this time are the almost simultaneous bilateral trading arrangements that are being discussed and negotiated between individual ASEAN countries with Japan and/or China, or bilateral trade agreements between Japan and South Korea, which portend to be the beginning of the larger EAFTA. But this different set of negotiations is leading to some sort of a hub-and-spoke trading arrangement with one country (the hub) having many different bilateral arrangements with many individual countries (spokes). This section analyses the economic benefits from this type of arrangement.

As in most other types of analysis of preferential trade, the framework shows that welfare effects are, theoretically, ambiguous. Positive gains depend largely on the increased market access in partner economies as well as on the ability, particularly of small ASEAN economies, to take full advantage of the market access opportunities. The challenge, therefore, is on the productive capacities of individual economies to supply those markets. Otherwise, most of the benefits of various regional or bilateral trading arrangements in East Asia, discounting the unambiguous consumer benefits, will redound more to the advanced economies because of their high production capabilities.

To start with, considering that Japan is already aggressively pursuing bilateral trade arrangements with each of the original ASEAN, the section first analyzes the effects of a hub-and-spoke arrangement in which Japan is the hub and the ASEAN6[5] are the spokes. What are the benefits to the individual spokes, as well as the hub? Next, we analyze what happens if the spokes also form an FTA among themselves. Note that this case is similar to forming a plurilateral FTA between ASEAN countries and Japan. Next, it looks at the benefits from a "two-hub arrangement" - ASEAN-China and ASEAN-Japan FTA, but without a China - Japan bilateral agreement. Finally, it considers the benefits of a plurilateral East Asian free trade agreement[6].

Japan as hub, ASEAN as spokes

The general framework of analysis is based on Baldwin and Wyplosz (2003) diagrams which highlights the discriminatory effect of preferential liberalization, i.e., the essential tradeoffs between volume effects and terms-of-trade loss from a free trade area[7]. The framework assumes a three country world: Home, Partner, and Rest of the World (ROW). Home and Partner engage in preferential trade between them, and the welfare effects are illustrated in Figure 1. The curves are the import demand function in Home and the two supply function in

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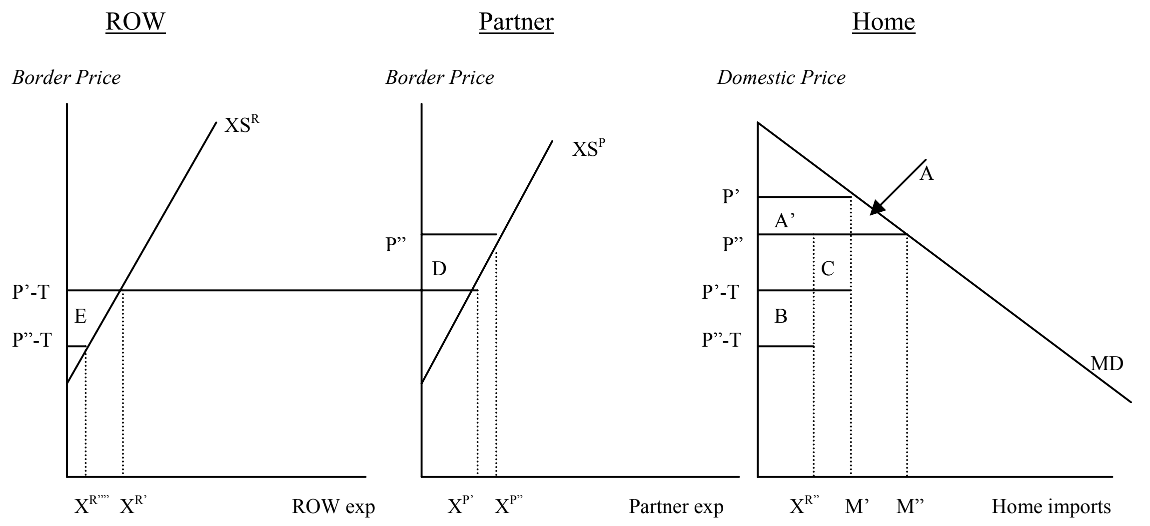
[5]Brunei, Indonesia, Malaysia, Philippines, Singapore, and Thailand.

[6] The analysis in this section would be the same if any other country, say South Korea instead of China, were the alternative hub.

[7] This tradeoff is preferred to Viner's trade diversion/ trade creation phraseology because the latter fails to capture all the welfare effects of discriminatory tariff liberalization. In particular, the trade diversion-trade creation term is slightly misleading (suggesting trade volumes are the key even though they refer to price changes) (Baldwin and Wyplosz, 2003). But the term remains an "effective tool of focusing policy makers' attention on the ambiguous welfare effects of preferential trading arrangements." (Panagariya, 1999)

Partner and ROW. Without tariffs, domestic price is where import supply which is equal to the sum of ROW and Partner's export supply (not shown in diagram) cuts import demand. With most-favoured-nation (MFN) tariff, domestic price in Home is P' (which is higher than tariff-free price not shown in diagram) while the border price (or the price faced by both ROW and Partner) is P'-T. Now, if Home and Partner agree to have bilateral free trade, the result is an increase in imports and conflicting border price effects, which becomes the source of welfare ambiguity[8].

Figure 1. Welfare effects of preferential trade agreement



Based on Figure 1, the welfare change for Home, on the import side, is represented by area A which comes from increased imports from M' to M" (volume effect), hence is positive[9]. Moreover, border price with respect to ROW drops from P'-T to P"-T, thus represents an additional gain for Home. The idea behind this is that ROW is forced to lower its prices to P"-T to be able to compete with Partner in Home market, thus making their goods cheaper for Home. The total area B represents the lower border price for all the imports from ROW, X_R". However, for the remaining imports from Partner, M'-X_R", Home pays a higher price of P" instead of the P'-T previously, hence takes a loss of C. Thus, the total net benefit on the import side is A+B-C. Note that the border price effect does not apply to M"-M' units because these were not imported before the preferential trade agreement. There is, thus, no point in comparing prices for these units pre- and post- PTA.

[8] The Baldwin-Wyplosz framework assumes symmetric-size markets. The ambiguity in welfare effect tends to disappear for Home if it partners with a low-cost country.
[9] Note that area A' is additional consumer surplus but since it is equivalent to the tariff revenue loss, it does not add to overall welfare for Home.

On the export side, assuming symmetric markets and same tariff levels, Home, likewise, gains access to Partner market, equivalent to Partners' access to Home market. Now, Partner increases exports from X_P' to X_P". Moreover, it receives a higher price for those exports from P'-T to P''. Thus total benefit on the export side is area D. In sum, net welfare change for both Home and Partner is equal to A+B-C+D. This net welfare change is either positive or negative depending on the areas A, B, C and D, which in turn, depends on the slopes of import demand and supply.[10,11]

Benefits for Hub

How does this analysis apply to Japan and individual ASEAN country bilateral trade arrangements?[12] One thing sure is that, if others form a bilateral agreement, it does not make sense not to form bilateral agreements with the hub as well. In the diagrams, notice that the ROW, the excluded country, loses through reduced import volumes and lower border prices, equivalent to twice the area of E because he loses in both Home and Partner markets. Welfare of the excluded country, therefore, is unambiguously reduced. This creates a 'domino effect' of bilateralism in that once some countries form bilateral arrangements, others tend to follow suit in order not to be closed off from its former trading partners' market. The implication is that since Singapore and Japan started on preferential trading arrangement, it is almost sure that other bilateral arrangements would be inked between Japan and other ASEAN countries for fear of trade exclusion.

For the hub country, i.e. Japan, the trade off is between the benefits from the free market access in each of its partner spoke country and the loss in the domestic market caused by increased competition as well as by the terms of trade deterioration (i.e. higher post-integration border price). Note that the benefits of Japan as hub come not only at the expense of the ROW (EU and US, for example) but also at the expense of its other spoke countries that do not have bilateral relations among themselves. Thus, if the Philippines and Thailand, for instance, do not

[10] Ibarra-Yunez (2003) arrived at similar conclusion using a different framework. In essence, he argues that increased welfare from bilateral trade agreement comes from: 1) increased profit abroad due to market access; and 2) domestic consumer surplus due to lower prices. Moreover, these two tend to outweigh the loss in tariff revenue and domestic profit reduction that results from greater competition at home and lower domestic output. The fact that the positive effect (from increase in consumer surplus and higher profits abroad) is counterbalanced by reduced domestic profits and tariff revenues means that there is a limit to networking or that there is an optimal number in a regional trading arrangement. This type of literature usually leads to the conclusion of an optimal number of trading blocs and/or size of the trade bloc.

[11] Actually, welfare effects of regional arrangements, and bilateral arrangements for that matter, are typically ambiguous at the theoretical level. Many questions are quantitative rather than qualitative, as sketched in the framework, that is why most researchers make use of methods like Computable General Equilibrium (CGE) models to assess relative benefits and costs of entering into such trade agreements. See, for instance, Harrison, et.al.,(2001) in the case of the impact of Chile's manifold trading agreements. However, the exercise in this paper is very useful in understanding some important intuition on the tradeoffs from these trade agreements.

[12] In the foregoing, much of the emphasis is on goods (and services) trade. Admittedly, additional economic argument for RTAs is the creation of knowledge capital and investment flows when bilaterals emerge, but these are not reckoned in the framework discussed. These additional benefits from investments and knowledge capital flows definitely add to the reasons on why bilaterals have flourished over the past few years since NAFTA.

have a bilateral trading arrangement, the Philippines (Thailand) will be considered as part of ROW in the Thai (Philippine) market as far as Japan-Thailand (Japan-Philippines) bilateral agreement is concerned.

Benefits for Spokes: Substitute vs. Complementary Agreements

Like the hub, the spoke country considers the same benefits (access) and loss (higher border prices) from the PTA (i.e. area A+B-C+D). However, in addition, its benefits tend to be further eroded for each new addition of a spoke, particularly if the new arrangement is a so-called *substitute* agreement. A *substitute* agreement is when a new spoke produce goods that are substitutes for those produced within the FTA (Kowalcyk and Wonnacott, 1992). Thus, if Japan obtains bilateral agreements with each of the ASEAN countries, the individual countries benefits are reduced each time a new spoke is added. Considering that ASEAN countries tend to produce and export similar goods, the implication is that the benefits from each country's bilateral agreement with Japan will diminish as each new trading agreement is concluded by another ASEAN country with Japan.[13] That is, Singapore's benefits from Japan-Singapore agreement may be reduced after Japan signs a separate agreement with the Philippines, or with Malaysia, through a strategy called 'additive regionalism'.

However, in so far as agreements are *complementary* in that imports from new spokes produce resources not previously available within the Free Trade Area, each newly concluded bilateral trading agreement with Japan can increase the benefits of the existing spokes. Thus, one can think of the vertically integrated production in the ASEAN, benefiting from each additional Japanese hub-and-spoke arrangement. Since each additional component for production enjoys free market access in the hub's market, these components can be exported to the hub and from the hub, re-exported to another spoke country. Such re-routing through the hub can reduce production cost in each of the spokes, assuming minimal transportation cost and very liberal rules of origin agreement. Furthermore, if income of both the hub and the new spoke increase as a result of a PTA, even if that agreement were a substitute agreement with respect to the original spoke PTA, it could become complementary if exports of existing spokes increase as a consequence. Thus, in the Japan-Singapore case, Singapore, as the original spoke, can gain from the possibility that an agreement between Malaysia and Japan can increase the income of both countries which consequently increases Singapore's exports to both.

In sum, the addition of each new spoke, in the case of substitute FTA, can erode the benefits of the original spokes' FTA with the hub. But, if incomes in the new spoke and the hub increase which induce an increase in the exports of the original spokes to both countries, then the substitute FTA may yet turn out to be a complementary FTA. But if each new additional hub-spoke arrangement turns out not to be complementary and diminish the benefits accruing to earlier spoke partners, does it make sense to enter into an FTA as one of the first few spoke countries? The answer, given our framework, remains yes. The reason is that, even in the case of

[13] Another way by which various other bilaterals can reduce the initial spokes' benefits (and the hub's) is through the increased administrative complications that come from the labyrinth of trade restrictions, particularly when rules of origin are inconsistent with one another.

pure substitute agreement, it may still be better to participate in the FTA as a spoke in a hub-and-spoke system than be an outsider to the trade agreements. As long as there is, on the whole, net benefits from free trade with the hub, regardless of how many spokes end up joining in, it is preferable to be inside the hub-and-spoke arrangement than be outside it.

The one important caveat is that the benefits which the spokes can derive from the FTA arrangement depend not only on the sufficient market access obtained in new markets but, more importantly, on whether that potential market access is actually taken advantaged of. For ASEAN countries with poor productive capacities, this is the crucial challenge because the enlarged foreign export market made possible by trade agreements could remain underexploited as a result of poor infrastructure support, low productivity, and unsupportive government institutions. If this happens, the regional trading arrangement would not bring about much higher profits abroad which could counterbalance the reduced domestic profits in the home market that results from opening it up to more foreign competition. Consumers, on the other hand, are definitely benefited by lower prices. Yet, since producers are better organized than consumers, producers' clamor and complaints about the adverse effects of free trade agreements on their total profits tend to downplay the overall benefits of FTA. This is one reason why, at times, developing countries are ambivalent about preferential trading arrangements.

2. AFTA: Spokes forming a bloc

What happens when the spokes, themselves, form a trading arrangement among themselves? In the case of ASEAN, how does the formation of the ASEAN Free Trade Area (AFTA) affect the hub-and-spoke arrangement centered on Japan? Closing the loop of bilaterals can substantially transform a hub-and-spoke arrangement to a plurilateral FTA with Japan. Of course, in this case, the plurilateral rules of origin would need to be reformulated and made consistent with one another.

Assuming that the hub is a higher cost producer, the spokes can restore some of the trade they used to have with each other that might have been switched to the hub as a result of the bilateral agreement. Moreover, both gain access to cheaper input that can allow them to compete better with the hub. So, while both 'spokes' benefit, the previous advantage (from volume) enjoyed by the hub can be reduced as a result of bilateral agreements among the spokes. But if the hub is a low-cost producer, then there will be no trade between the spokes that can be switched back. In this case, a low-cost hub will not be negatively affected by a preferential trade agreement among its spokes.

Certainly, the hub gains more in a hub-and-spoke arrangement than in a plurilateral FTA (i.e. in a situation where all the spokes also form an FTA among themselves) because of the preferential market access it gets in each spoke market. With the spokes forming an FTA among themselves, the hub has, essentially, more competitors in each spoke market. The positive note is that the income of spoke countries may increase under such plurilateral FTA, thereby increasing hub's exports in each of these markets. Moreover, for both hub and spokes, a plurilateral agreement would be less costly. In a hub-and-spoke system, the administrative costs are high because each has to keep track of all the rules of origins negotiated in the different bilaterals, and particularly so if those bilateral agreements do not have consistent rules of origin.

Likewise, transport costs can be higher in a hub-spoke system if spokes, to avoid high tariffs in a country with which it has no FTA agreement, end up re-routing its exports to that country through the hub[14].

Thus, in sum, the welfare of both spokes and hubs may increase under one integrated agreement. Why, then, do countries not engage in plurilateral agreements straightaway, instead of negotiating several bilateral agreements? One reason is that bilaterals have the advantage of enabling countries to tailor an agreement to their own special needs, making deeper liberalization possible. To illustrate, the Mexico-US agreement was far more liberalizing than the Uruguay Rounds Agreement; the same with the Japan-Singapore Agreement which contains not only goods liberalization but also investments and competition provisions. In contrast, in plurilateral agreements, the agenda may be set or heavily influenced by third countries with other problems which may be unrelated to the problems of another country. Countries in plurilateral agreement may not also share the same sense of urgency regarding particular issues. An example is the 'convoy' problem in plurilateral agreements in which the pace of the entire trade bloc tend to be determined by its most hesitant member. Particularly, in the ASEAN context in which decision making is done by consensus, the convoy problem can backstop greater liberalization in the entire region as a whole. In all these possibilities, bilaterals may offer a superior arrangement than regional agreements.

In the above analysis, we started off with bilaterals in a hub-and-spoke arrangement that eventually turn into a plurilateral agreement when the spokes also form bilaterals among themselves. However, in the ASEAN context, we observe a different sequence of trade arrangements. In particular, ASEAN countries already have a regional FTA in existence which is the AFTA, while the bilaterals are just coming in. In other words, the spokes already have existing FTAs, while the hub-spoke system has still to be formed, with Japan as purportedly the center. How does a different initial condition affect the welfare analysis for the participants in the trade agreements?

The actual situation is similar to a backdoor accession by Japan to an existing FTA via bilateral arrangements with each of the members. In this case, the spokes (specially ASEAN-5) compare the benefits of gaining access to the Japanese market with the losses from having to share its original preferential market in ASEAN with Japan. If a Member reckons that the net benefit is positive, it agrees to a bilateral agreement. Japan, on the other hand, compares the cost of opening up its own market to the benefits of getting improved access to ASEAN's preferential market. Arguably, in Japan's reckoning, positive net benefits only come from improved market access in ASEAN-5, rather than from the entire ASEAN-10, hence it pursues bilateral agreements only with these five countries.

In terms of benefits, however, the analysis remains broadly similar. The hub (Japan) still competes with other spokes in ASEAN preferential market and thus benefits less from it compared to a situation in which its spokes do not have their own bilateral agreements. Yet, at the same time, it benefits from the higher income in each of its spoke market which results from their own independent bilateral agreements. The spokes, too, benefit from its bilateral agreement

[14] Though, admittedly, well-designed rules-of origin can prevent this from happening.

with the hub, but increases its overall benefit if it also forms bilateral agreement with the other spokes.

3. China as another hub[15]

If China forms separate bilateral trading arrangement with each ASEAN country, it gets the same benefits that Japan could get as a hub, namely preferential market access in each of the ASEAN countries it signs an agreement with. In the three-country framework discussed earlier, China is certainly better off negotiating bilateral trade agreements than be excluded in the ASEAN markets. The spoke partners from ASEAN, on the other hand, would enjoy free market access in the large home market of China as well as that of Japan. Yet, again, the challenge here is whether ASEAN countries have sufficient capacity to supply the markets that are opened for them by the trade agreements.

That China becomes another hub like Japan, clearly reduces the benefits of Japan as hub, in the same way that spokes' benefits are reduced by each new addition of a *substitute* agreement. But if the agreements of ASEAN with China is complementary to that of Japan-ASEAN, then Japan's benefits from its hub-spoke arrangement with ASEAN countries are increased with China's new hub-spoke arrangement in the region. Question is whether China-ASEAN agreements would be substitute or complementary agreements with Japan-ASEAN trade agreements. The answer is likely yes, if only for the fact that access to the large Chinese market can increase the income of ASEAN and thus, consequently, increase exports of Japan to the ASEAN spoke economies. Conversely, Japan's bilateral agreements with ASEAN countries, can be complementary to the China-ASEAN agreements and are thus beneficial for China, as well. In addition, considering the difference in production structure of China and Japan, the ASEAN-China trade agreements might be complementary to Japan-ASEAN, in the sense that previously unavailable imports in the Japan-centered ASEAN trade agreement become available if China-ASEAN agreement exists. Furthermore, if those imports are inputs to Japanese production, Japan enjoys additional benefits from the China-ASEAN agreement.

4. *East Asian FTA*

If China and Japan (and for that matter, Korea), likewise, form a bilateral agreement, then the loop is closed for the region to have, essentially, a regional trading arrangement (RTA) or a plurilateral agreement among East Asian economies. ASEAN countries' advantage as 'hub' to the two countries is reduced, assuming that rules of origin are reformulated to be consistent with one another. But everyone is eventually better off, including ASEAN, because of the resulting increase in regional trade. An East Asian FTA, therefore, should, theoretically, result to higher welfare for all[16].

[15] This analysis as well the next section's on the EAFTA can easily be extended to Korea.

[16] Albeit, the impact to each individual economy, will vary and will greatly depend on how well each is able to take advantage of a growing export market.

III. ASEAN Role in East Asian Integration

While the above analysis shows that Japan and China's engagement in the region bring economic benefits and is, consequently, a fundamental driving force that can steer greater integration, these two economies are, at the same time, political rivals that are vying for leadership position within East Asia. Japan has, so far, been the leading economic power in Asia and the one that has influenced industrial development and economic growth in the region. But its decade-long recession is weakening its edge. It also has to deal with its "history" problem as well as complications brought about by individual Asian's claims for compensation for wartime sufferings.

China, on the other hand, has had phenomenal export and income growth, even during the Asian crisis. It is a source of cheap labor and is a large domestic market by itself, thus attracting more investments than the NIEs or ASEAN. With its preferential trading arrangement with the rest of the region, it has the opportunity to replace Japan as the Asian leader that can influence global economic agenda. But, at the same time, China is still perceived as a security threat: its military expenditures have been expanding and the issues related to Taiwan remains like the sword of Democles hanging over Asian peace and stability. China is also seen as a competitor of ASEAN not only in many export products but also in attracting foreign direct investments (FDI). Thus, ASEAN, too is wary of China.

With Japan and China political rivalry as a backdrop, ASEAN and even South Korea has an important role to play to glue all the countries together into the East Asian FTA. It has been said that what Asia lacks is leadership of the kind that France and Germany played in the EU, or US in the NAFTA, because China and Japan have their own image and domestic economic problems. Still, ASEAN can play the important role of a broker, a benign mediator if you will, for the EA FTA to move progressively beyond political statements. After all, wasn't it the ASEAN's initiative that made the historical first ASEAN + 3 Summit possible in 1997? The fact is that, given Asian culture, a leader of the western type would also likely not be accepted in Asia. Rather, a quiet, less threatening, one would do a more effective job. ASEAN, in this sense, fits the bill because Japan and China both trust ASEAN and see in it no threat, because it has no ambition for political hegemony, it has no ambition to dominate but rather to become partners in Asia. But can ASEAN rise to this challenge?

'ASEAN' Way

Soesastro (2002) describes the ASEAN way as a "non-confrontational attitude, a willingness to see the point of view of another, a conscious refrain from exerting influence or coercion over other member states and a willingness to be patient and persevere in reaching consensus." It reflects conventions, culture and customs prevailing in Member States, where the way of dealing with one another is through a manifestation of goodwill and the slow winning and giving of trust.

With the hindsight of history, the ASEAN way, though slow and time consuming, has served the organization well in solving problems, harmonizing diverging interests, and managing conflicts among member states. From the beginning, by not forcing its incredibly diverse and mutually suspicious members into legally binding standards, and relying rather on informal agreements, the ASEAN has, over the years, done a remarkable job of moving its members from animosity and distrust to close cooperative relationship. It is interesting to note that even the 1967 Bangkok declaration upon which ASEAN was founded was a mere two-page declaration and certainly was no Treaty of Rome (Severino, 2001b).

But would this evolutionary approach, relying on patient consensus-building to arrive at informal understandings or loose agreements, work for the EAFTA? Already, the ASEAN way of consensus-based decision making has frustrated APEC efforts to speed up the pace of trade liberalization. What more for EAFTA with the even deeper political ramifications it implies. The perception outside the region is that consensus based decision making has become a weakness limiting the growth of ASEAN as an organization, and diminishing its potential of effectively brokering the EAFTA.

If ASEAN were to take an effective lead in bringing forth the EAFTA, one solution is to adopt a more flexible approach, relying perhaps on a 'coalition of the willing' to set the pace for the rest of the region, or alternatively, changing the decision process to majority voting. But, so far, there is reluctance to change the 'consensus' process.

Diversity of Membership

ASEAN's diverse membership also makes greater integration with East Asia difficult. Not only do members have different levels of economic development, they also have widely divergent political systems. Some are democratic and prosperous, while others are still partly socialist and very poor. Some, like Singapore, are relatively pro-globalization, while others are hesitant to give out more and more trade commitments. ASEAN countries also have varied strategic and security concerns. With diverse levels of economic development, extensive trade liberalization even among ASEAN members is difficult; what more with the richer East Asian countries. The lack of relative economic homogeneity is compounded by the respective internal instability in individual ASEAN country, which diverts priority away from regional integration efforts. So then, if ASEAN, could somehow not put its own house in order, how can it lead the formation of EAFTA?

Loose Institution

ASEAN's ambivalence towards institutionalization is another characteristic that hampers its potential lead role in the EAFTA. Within ASEAN itself, it operates mostly through ad hoc understandings and informal procedures rather than within the framework of binding agreements which are arrived at through a formal process (Severino, 2001b). The ASEAN process mostly involves numerous meetings at different levels (heads of states, ministers, senior officials, committees) which usually reach informal understandings that are not legally binding. Thus, "regional economic integration seems to have become stuck in framework agreements, work programs and master plans" (Severino, 1999).

However, since AFTA, ASEAN has increasingly relied on more legally binding agreements, for instance, the ASEAN Framework Agreement on Services (AFAS), or the e-ASEAN framework agreement. This has come from the growing realization that closer regional economic integration requires commitments that are clear, firm, and enforceable, and thus need to be based on binding legal foundations. This also helps in the policy lock-in by member countries because non-fulfillment of country commitments could possibly imply some form of sanctions.[17] For instance, if a country retreats for its tariff liberalization commitments, other countries can demand compensations or can retaliate in some forms. It is likely that the developing rules-based regime in trade will gradually extend to other areas of ASEAN cooperation, particularly those relating to transnational problems as marine environment, the preservation of biodiversity, money-laundering, drug trafficking, etc.(Severino, 2001b).

Institution-wise, ASEAN is devoid of a body like the European Commission to implement its programs and to ensure compliance with such agreements and measures, or the European Court of Justice to adjudicate ASEAN disputes. The Indonesia-based ASEAN Secretariat has no supranational authority or responsibility, unlike the European Commission. Negotiations with ASEAN, properly speaking do not take place with the ASEAN Secretariat, but with each individual country because ASEAN is not represented by a monolithic body. ASEAN is rather a loose voluntary organization of sovereign states that have not yielded their sovereignty to a central authority.

Yet for closer economic integration, countries may have to yield some degree of sovereignty, the ASEAN Secretariat would have to be allowed to wield some extent of supranational authority, and more binding agreements rather than informal understandings may be needed to manage the integrated economy and the problems that transcend national boundaries. The question is whether its members have the vision and political courage to take that leap.

Integration of the Spirit

Greater institutionalization of ASEAN to manage the integration process, in turn, requires greater mutual trust among ASEAN members. How can trust grow? Through a deep sense of community and popular support for regionalism. However, the rich diversity of cultures have not yet allowed the region to feel one. A change of mindset, of thinking regional rather than each nation to its own, is what is required. To this end, initiatives on various regional cooperation in culture, regional education exchange network, cultural exchange can help towards improving a sense of a regional identity.

IV. Summary and Conclusion

ASEAN is an important regional organization. It had achieved several milestones, remarkable for an organization originally conceived to be only a talking shop for resolving security issues in a peaceful way. It is making efforts towards greater integration of its economies through the AFTA. ASEAN may not be economically important compared to China

[17] Even though, thus far, there is no effective trade dispute settlement system in ASEAN similar to that of the World Trade Organization (WTO)

or Japan but, politically, it has a potentially vital role as mediator or broker of a far bigger and more challenging economic integration - that of the entire East Asian economies.

But ASEAN needs to rise up to the challenge. Several factors hamper it from exercising this important role in East Asia namely, its slow decision making process, its lack of centralized institutions with supranational authority, its diversity and lack of unity.

The current phenomenon of hub-and-spoke bilateral trade agreements between individual ASEAN and Japan or China offers potential net benefits, particularly when positive investment effects form part of the reckoning. But the benefits for all countries would be bigger still if the region forms an FTA.

Given the difficulties in the formation of the EAFTA, the bilateral agreements could become the building blocks for East Asian regional integration. Since bilateral arrangements are carefully designed so that no particular challenge is too overwhelming, political resistance towards a larger trade arrangements in East Asia can be overcome. The successful experience of relatively easy reforms could change expectations and open up opportunities for more difficult reforms down the road (Munakata, 2002)[18].

To a certain extent, they are also a way of going around the slow decision process which marks the 'ASEAN way'. Since the bilaterals are between two countries that are willing and able to commit and accept trade concessions in each other's market, these agreements create some sort of 'coalition of the willing' that can, eventually, set the pace of integration for the rest of East Asia. Bilateral trade agreements can increase the pressure on other hesitating economies to soon follow suit because delays mean that they could find themselves excluded from a rapidly integrating market. With the 'domino effect', the coalition of the willing can then, eventually, embrace the entire region.

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[18] It should be noted, however, that a common framework for all ASEAN is needed, if they have to go via bilaterals. Otherwise there will be a complete tangled-up spaghetti arrangement, especially in the Rules Of Origin. So far Singapore has been the pioneer but it is not advisable for other ASEAN to follow the model because Singapore is sui generis – it has no agriculture interests and has the administrative capacity to handle the details in complex FTA negotiations. Other ASEAN countries do not have the same financial and human resources as Singapore.

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